The Honorable Ricardo S. Martinez

IN THE UNITED STATES DISTRICT COURT FOR THE
WESTERN DISTRICT OF WASHINGTON

UNITED STATES OF AMERICA, Petitioner, v. MICROSOFT CORPORATION, *et al*. Respondents.	Case No. 2:15-cv-00102 RSM **UNITED STATES' RESPONSE TO MOTION FOR EVIDENTIARY HEARING**

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To obtain an evidentiary hearing, Microsoft must show "specific facts and circumstances plausibly raising an inference of bad faith" or improper motive. Even if Microsoft meets this high burden, however, in order to obtain *discovery*, Microsoft must also make a "substantial preliminary showing of abuse or wrongdoing." But the "facts" set out by Microsoft do not come close to making either showing. The gravamen of Microsoft's argument is that the law firm Quinn Emanuel's involvement in the 2004-2006 Examination — which began only in 2014 — is what makes enforcement of these summonses "an abuse of the Court's process."

Microsoft contends that it raises two issues of first impression. The first issue is a purely legal argument: Microsoft contends that Quinn Emanuel's participation in the Examination violates federal law because allowing Quinn Emanuel attorneys to question witnesses during a summons interview amounts to outsourcing an inherently governmental function. In furtherance of this argument, Microsoft contends that a temporary Treasury regulation providing for such participation is invalid. Although Microsoft might want discovery to make this argument, that is not the standard for discovery in a summary summons enforcement proceeding, as Microsoft has not come forward with any evidence that raises factual issues about the validity of the regulation. Second, Microsoft raises another, largely legal argument — with a few factual allegations sprinkled in, based on select terms of the Quinn Emanuel contract, the timing of certain events, and speculation about the IRS's FOIA compliance — to contend there is an inference of abuse. To the extent Microsoft has made any factual showing, the inferences it draws are based solely on reasoning that, because Quinn Emanuel's contract was executed in May 2014, everything that follows is suspect. This is a logical fallacy. As shown below, and based on the Second Declaration of Mr. Hoory, the facts are not as Microsoft speculates: Quinn Emanuel was retained simply to provide support to the ongoing IRS examination, and did not begin work on the

contract until July 2014. In light of the actual facts, all of the inferences necessary for Microsoft's arguments for an evidentiary hearing and for discovery disappear.

BACKGROUND

1. The Issues in the 2004-2006 Examination

The primary remaining areas on which the IRS needs additional information for the 2004-2006 Examination are transfer pricing issues[1] involving intangibles and relating to two regional cost sharing arrangements between Microsoft and its affiliates, one between Microsoft and its Puerto Rican affiliate, Microsoft Operations Puerto Rico, LLC[2] ("MOPR") (the "Americas cost sharing arrangement") and the other between Microsoft and its Asian affiliate, Microsoft Asia Island Limited, a Bermuda corporation ("MAIL") (the "APAC cost sharing arrangement"). Second Declaration of Eli Hoory ("Second Hoory Declaration") ¶ 5.

Under the Americas cost sharing arrangement, Microsoft divided rights to technology intangibles (*e.g.*, software code) from rights to non-technology intangibles (*i.e.*, everything other than technology intangibles, such as brands, trademarks, and customer/partner relationships). Microsoft and MOPR entered into a technology license agreement under which Microsoft licensed to MOPR — and subsequently treated MOPR as the economic owner of — various rights to technology intangibles used in Microsoft's Americas retail business and, under a cost sharing agreement, MOPR agreed to fund technology research and development ("R&D") costs

[1] Transfer pricing generally, and as embodied in 26 U.S.C. § 482, refers to the prices that related parties charge one another for goods and services transferred between them. The most common application of the transfer pricing rules is the determination of the correct price for transfers between related entities. The IRS is authorized under section 482 to allocate income and deductions among commonly controlled or owned entities as necessary to prevent tax avoidance or to clearly reflect the income of such entities. In particular, when rights to intangible property are transferred or licensed between related entities, "the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible." 26 U.S.C. § 482. "[T]he standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer." Treas. Reg. § 1.482-1(b)(1).

[2] MOPR is owned by a Bermuda holding company and is not a member of Microsoft's U.S. consolidated group. Second Hoory Declaration ¶ 5.

relating to Microsoft's Americas retail business. Microsoft retained the rights to all non-technology intangibles used in its Americas retail business. *Id.* ¶ 6. This ongoing division between technology intangibles and non-technology intangibles is unique to the Americas cost sharing arrangement and is not a feature of the APAC cost sharing arrangement. *Id.* ¶ 7. In addition to a technology license agreement and a cost sharing agreement, the Americas-related transactions included a series of other intercompany agreements. *Id.* ¶ 8.

In support of the related-party pricing it reported on its returns for purposes of I.R.C. § 482, Microsoft relied on a residual profit split model to value and price the Americas intercompany transactions. The model set intercompany pricing for intangibles based on a percentage of Americas retail sales of Microsoft products by Microsoft to third-party customers. There were four different sets of payments under the Americas cost sharing arrangement (*id.* ¶ 9)

- Buy-in royalty (for technology intangibles): MOPR would pay Microsoft a percentage of sales each year, declining from 44.23% of sales in 2006 to 2.56% in 2014, with no buy-in royalty due after 2014.
- R&D costs: MOPR would pay Microsoft for R&D, forecast to equal approximately 11.9% of sales per year.
- Technology payment (for technology intangibles): Microsoft would pay MOPR a royalty equal to 53.68% of sales in 2006 and was forecast to pay MOPR between 53.15% to 50.93% of sales between 2007 and 2015.
- Standard costs: Microsoft would pay MOPR compensation for standard (*e.g.*, manufacturing) costs, forecast to equal approximately 1.3% of sales per year.

Netting these forecast payments between Microsoft and MOPR, the model predicted that MOPR would net approximately $38.58 billion during the period from 2006-2015. The IRS Examination is investigating whether the intercompany pricing established by Microsoft is consistent with the arm's length standard under I.R.C. § 482. The value of what Microsoft transferred — the rights to technology intangibles — and the value of what Microsoft kept — the non-technology intangibles — are both at issue. *Id.* ¶ 10.

2. The initial phase of the Examination

On May 3, 2011 the IRS examination team issued Microsoft a "30-day" letter, reflecting a notice of proposed adjustment on the Americas cost sharing arrangement (as well as other proposed adjustments, including one with respect to the APAC cost sharing arrangement).[3] *Id.* ¶ 12. The notice did not propose any adjustment to the "transfer price" that Microsoft paid to MOPR after July 1, 2005, thus leaving in place Microsoft's profit split between the technology intangibles it transferred and the non-technology intangibles it retained. *Id.* ¶ 14.

3. The TPO phase of the Examination

In recognition of the complexity of examining transfer pricing issues, the IRS's Large Business & International Division, which oversees the examinations of large corporate taxpayers like Microsoft, established a team of transfer pricing specialists within a new unit, Transfer Pricing Operations ("TPO") in 2011. *Id.* ¶ 16. TPO provides IRS agents with centralized support in planning, executing, and resolving transfer pricing examinations. *Id.*

a. TPO withdrawal of 30-day letter

Once TPO began reviewing the IRS's existing transfer pricing inventory, it identified Microsoft's transfer pricing issues as among the largest transfer pricing issues the IRS had, potentially involving tens of billions of dollars in U.S. taxable income. *Id.* ¶ 17. Moreover, TPO realized that the issues the original IRS examination team had identified in the 30-day letter did

[3] An IRS 30-day letter to a taxpayer contains a report with proposed adjustments to a taxpayer's return and invites the taxpayer to agree with the proposed changes or, if the taxpayer does not agree, to request a meeting or teleconference with the supervisor of the IRS examination point of contact identified in the letter. If a disagreement remains after the meeting or teleconference, the 30-day letter invites the taxpayer to request a conference with IRS Appeals. See, Saltzman, IRS Practice and Procedure ¶ 9.05 (2013); Treas. Reg. § 601.105(c), (d). If a taxpayer does not respond to a 30-day letter or if no agreement is reached at Appeals, the IRS generally issues a statutory notice of deficiency (a "90-day" letter), which reflects a final determination, rather than a proposed adjustment. I.R.C. § 6212 (providing for issuing a statutory notice of deficiency). After receiving a 90-day letter, a taxpayer may file a petition in Tax Court to dispute the deficiency determination made by the IRS.

not address some significant aspects of the Americas cost sharing arrangement, including the technology royalty Microsoft was paying. *Id.* ¶¶ 14, 19, 20. TPO determined that, to understand Microsoft's business better, it needed to consult with non-governmental software industry experts, which the examination team had not done. *Id.* ¶¶ 18, 19. After communicating these concerns to Microsoft, TPO withdrew the IRS's 30-day letter in February 2012. *Id.* ¶ 21.

b. The Examination from mid-2012 through mid-July, 2014

As part of its renewed fact-gathering process, between July 2012 and October 30, 2014 the IRS continued to issue to Microsoft international-issue information document requests (IDRs). *Id.* ¶ 71. The IRS also held informal interviews with Microsoft employees. *Id.* ¶¶ 26, 27. At the request of Microsoft's tax department, the interviews held during 2012 and 2013 were not recorded. *Id.* ¶ 28. As early as 2012, and on more than one occasion during 2013, the IRS expressly informed Microsoft, that it might "pursue more formal interviews" at a later point. *Id.* ¶¶ 28, 31; see Exhibits B, C.

In keeping with its commitment to be as transparent as possible about the progress of the Examination, the IRS prepared and shared with Microsoft its projected timelines for completing the Examination. *Id.*¶ 23. Beginning in mid-2012, TPO also held periodic executive-level conference calls with Microsoft executives. *Id.* ¶ 22. In addition, separate calls were held between the IRS examination team and Microsoft's tax department to discuss day-to-day examination matters, including regular information document request (IDR) status calls. *Id.*

A timeline issued in July 2012 contemplated that the Examination would be resolved or a 30-day letter issued by July 1, 2013. *Id.* ¶¶ 23-25 and Exhibit A. Subsequently, the IRS prepared — and shared with Microsoft — updated timelines that pushed back this deadline,

ultimately to April 1, 2014, primarily because the IRS did not receive the information it needed within the anticipated timeframes.[4] *Id.* ¶ 30 and Exhibits B and C.

In January 2014, the IRS made a detailed, in-person presentation of some of its expert reports and its work to date on the Examination to Microsoft executives, including Microsoft's counsel, Baker & McKenzie. *Id.* ¶¶ 34-37. At the conclusion of the meeting, based on discussions with Microsoft personnel in attendance, the IRS understood that the parties would be following up on technical issues and also that Microsoft would be making a similar in-person presentation, with Microsoft's views. *Id.* ¶ 38.

Although the parties periodically spoke about the in-person presentation by Microsoft, *see id.* ¶¶ 41, 45, no such presentation was ever scheduled or held. *Id.* ¶ 39. On February 17, 2014, at an executive-level call with the IRS, Microsoft stated that it would not pursue resolution discussions and would like the IRS to issue a 30-day letter. *Id.* ¶ 41. The IRS then turned to completing its factual development, while also continuing to attempt to resolve with Microsoft such issues as math corrections and revenue and expense allocations. *Id.*

To complete its fact-finding, the IRS made additional document requests to Microsoft between January and June 2014. *Id.* ¶ 46. The IRS held additional discussions with Microsoft's tax department, in March 2014 and continuing into May, on resolving some of the technical issues. *Id.* ¶¶ 43-45. At a March meeting, the IRS also discussed with Microsoft the formal interviews of Microsoft employees, which it estimated would occur in the July through September 2014 timeframe. *Id.* ¶ 44.

[4] The January 2013 timeline noted that the dates had been adjusted because Microsoft was regularly taking four to five weeks to respond to the IRS's document requests, rather than the initially expected two weeks. *Id.* ¶¶ 29, 30 and Exhibit B. The May 2013 timeline noted that the dates had been further adjusted, largely due to Microsoft's requirement that the IRS's outside experts could review software source code only in Microsoft's "clean room" facility in Redmond Washington (instead of at either the experts' or Microsoft's facilities in Massachusetts). *Id.* ¶¶ 30, 32 and Exhibit C.

Consistent with the timeframe the IRS had given Microsoft in March about identifying potential witnesses to interview, the IRS provided Microsoft eleven draft IDRs on July 3, 2014. *Id.* ¶ 47. On receiving the drafts, Microsoft requested an executive-level conference call with the IRS. *Id.* ¶ 48. On that call, held July 9, 2014, a Microsoft executive stated unequivocally that Microsoft had no interest in continuing with any resolution discussions, and repeated Microsoft's preference (expressed earlier, in February 2014) that the IRS issue a 30-day letter. *Id.* At this juncture, the IRS fully shifted its focus from possible resolution to completing its fact-finding on all open issues in the Examination. *Id.*

The IRS issued the eleven IDRs on July 11, 2014. *Id.* ¶¶ 50-51. These IDRs sought both documents and identities of Microsoft business units and employees who had historical management and decision-making responsibility in certain subject areas. *Id.* ¶ 54. The IRS sought the names of employees in order to determine whom it should interview. *Id.* ¶ 62. The IRS also issued six additional document-only IDRs between August and October 2014. *Id.* ¶¶ 55-57.[5]

4. The involvement of Quinn Emanuel in the examination

Given the fact-intensive valuation issues presented and the number of outside experts involved in the 2004-2006 Examination, TPO concluded that — in addition to the outside software industry experts and additional economics experts whose assistance it had sought — the IRS would also benefit from having an independent analysis from, and examination support by,

[5] Although, in response to the IRS's information document requests, Microsoft produced to the IRS, in the time period between July 2012 and July 2014, approximately 1.14 million Bates-stamped pages, approximately 1.13 million of those pages were in response to just two IDRs and, while nominally responsive, were mostly third-party syndicated research to which Microsoft subscribed and which it had apparently collected in an online research library. *Id.* ¶ 52. After the IRS expressed concerns that none of the produced information appeared to reflect Microsoft's own research, Microsoft made a supplemental production of approximately 993 documents that included what appears to be Microsoft-commissioned research. *Id.* Even this supplemental production was mostly not responsive to the 2004-2006 Examination, however, as it was almost entirely from after 2006 or focused on Microsoft products not covered by the Americas cost sharing arrangement. *Id.*

seasoned commercial litigators who had experience presenting, defending and critiquing fact-intensive and expert-dependent positions. *Id.* ¶ 76.

The IRS awarded a contract to the commercial litigation firm Quinn Emanuel in May 2014. *Id.* ¶ 78. Quinn Emanuel was not cleared to perform any work for the IRS until July 2014, however, as the IRS needed to complete certain procedural and administrative requirements, including performing background checks on Quinn Emanuel personnel before they could start work.[6] *Id.* ¶¶ 79, 80. Not until July 15, 2014 did Quinn Emanuel receive from the IRS the initial tranche of information necessary for the firm to start its review and analysis of the examination to date. *Id.* and Exhibit G. Accordingly, July 15, 2014 was the first date Quinn Emanuel could, and did, perform any services under the contract. *Id.* ¶ 80.

Quinn Emanuel's role is to provide the IRS examination team and the transfer pricing team members in the TPO with "the services of . . . an expert in commercial litigation" that will "consult with . . . and/or advise the Service" in connection with the 2004-2006 Examination (Contract, p.5 [Docket 36-4, p.7].) The contract provides that Quinn Emanuel will provide services described as "Evaluation & Case Support." (*Id.*, p.7 [Docket 36-4, p.9].) The contract further provides that Quinn Emanuel "will *assist* the Service in preparing, organizing and presenting the factual record and legal analysis of the case" and "will work collaboratively with the Service to *support* the examination." *Id*., p.8 [Docket 36-4, p.10].) (emphasis added.) The contract contemplates that the Service will be making all third-party contacts, and specifically prohibits Quinn Emanuel from making any third-party contacts without express written

[6] The Quinn Emanuel contract identifies five attorneys and a paralegal as providing services under the contract. See Contract p.B-2 [Document 36-8, p.12].

permission from the Service. *Id*., p. 11 [Docket 36-4, p.13].) The contract also unequivocally prohibits Quinn Emanuel from performing "inherently governmental functions."[7] *Id.*, p. 16.

The July IDRs were drafted, prepared, and issued by IRS employees without any input from Quinn Emanuel. Second Hoory Declaration, ¶ 81. Quinn Emanuel's only input on these IDRs was limited to consulting on an August 2014 revision clarifying the scope of one particular IDR. *Id.* The IRS — not Quinn Emanuel — identified the need for clarification, due to its concern that Microsoft was construing the original request more narrowly than the IRS intended. *Id.* The August and October IDRs were also drafted, prepared, and issued by IRS employees without any input from Quinn Emanuel. *Id.* ¶ 82.

In August, for the first time after starting work and conducting an initial review of the materials provided by the IRS, Quinn Emanuel met with IRS personnel to discuss the record to date on the Service's investigation of Microsoft's Americas transaction. *Id.* ¶ 83.

Mr. Hoory disclosed to Mr. Bernard, in Microsoft's tax department, in a letter dated August 28, 2014 [Dkt 37-2, Ex. B, p.4], that the IRS had retained outside counsel from Quinn Emanuel "to assist LB&I in its evaluation and examination" and that Quinn Emanuel attorneys might attend the upcoming interviews. The disclosure was made prior to the interviews, which was first time Quinn Emanuel attorneys would have any direct contact with Microsoft employees. In a September 9, 2014 letter to Microsoft, Mr. Hoory clarified that the IRS did "not have an engagement letter with" Quinn Emanuel [Dkt 37-2, Ex. D]; in a letter sent the following

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[7] The contract states:

> [t]he Contractor shall not have the authority to perform inherently governmental functions as described in OFPP Policy Letter 11-01 including, but not necessarily limited to, any government policy-making, decision-making, portraying the Contractor as a representative of the government or performing governmental managerial responsibilities

Id., p. 16 [Docket 36-4, p.18].)

day, September 10, Mr. Hoory provided Microsoft, at its request, a copy of the full scope of work (Section C) of the Quinn Emanuel contract. [Dkt 37-2, Ex. F.] As reflected in that letter and in the contract provided to Microsoft, Quinn Emanuel's contract is limited to providing examination support to the IRS. *Id.* ¶ 90.

Quinn Emanuel attended some of the Microsoft employee interviews held in September and October 2014. *Id.* ¶ 84. Consistent with the procedures negotiated with Microsoft for these consensual interviews, IRS employees conducted all these interviews, with Quinn Emanuel limited to asking follow-up questions. *Id.* In a number of cases, Microsoft's attorneys objected to such follow-up or instructed its employees not to answer further questions from Quinn Emanuel. *Id.* Quinn Emanuel also consulted with and provided advice to the IRS personnel conducting the interviews during and between interviews. *Id.*

Following its review of documents provided by the IRS and after participating in and reviewing transcripts of the September and October interviews, Quinn Emanuel completed its independent assessment of the IRS's work to date on the Americas cost sharing arrangement and of Microsoft's transfer pricing position. In November 2014, Quinn Emanuel's attorneys presented to TPO, IRS Counsel, and IRS executives their evaluation and analysis, as experienced commercial litigators, of the positions taken by the IRS and by Microsoft. *Id.* ¶ 85.

Quinn Emanuel did not prepare initial drafts of any of the summonses the IRS issued. *Id.* ¶ 86. For some (but not all summonses), Quinn Emanuel was given an advance copy of a late-stage draft of a summons for documents. *Id.* This included, for example, reviewing a draft of the designated summons and providing comments to the IRS drafters. *Id.* Quinn Emanuel was not provided with an advance copy of all of the related summonses, several of which focused on the APAC transaction, which was not the focus of Quinn Emanuel's contract. *Id.*

IRS employees identified and selected all candidates for summons interviews. *Id.* ¶ 87. With respect to the potential interviews, the IRS consulted Quinn Emanuel on prioritizing interviewees from the identified candidate pool, and discussed the subject matter and goals for the various potential interviewees. *Id.* IRS employees decided who would be summoned to give testimony. *Id.*

ARGUMENT

I. Microsoft has not met its burden of establishing entitlement to an evidentiary hearing.

The United States has met its burden of establishing good faith in issuing the summonses at issue. The Court found that the United States has made the requisite *prima facie* showing to obtain enforcement of the summonses at issue by establishing that the factors enunciated in *United States v. Powell*, 379 U.S. 48, 57-58 (1964), have been met. *See* Order to Show Cause and to Set Briefing Schedule (Dkt. 23). The Court also noted that the burden has shifted to Microsoft to show cause why the summonses should not be enforced. *Id*. Once the government makes its *prima facie* case for enforcement through submission of the Revenue Agent's declaration, as has been done here, a "heavy" burden is placed on the taxpayer to defeat enforcement by showing an "abuse of process" or "the lack of institutional good faith." *Fortney v. United States*, 59 F.3d 117, 119 (9th Cir. 1995).

Prior to the court ruling on enforcing the summons, however, Microsoft filed the instant motion for an evidentiary hearing pursuant to *United States v. Clarke*, 134 S. Ct. 2361 (2014). In its memorandum in support of its motion, Microsoft contends that it is entitled to an evidentiary hearing because it alleges that (1) the IRS is attempting to outsource to third-party contractors an inherently governmental function, questioning a taxpayer and its employees, and (2) the facts and circumstances raise a plausible inference that the IRS has impermissibly outsourced to the

Quinn Emanuel trial lawyers other key aspects of the IRS's examination of Microsoft. Neither of these bases plausibly raises an inference of bad faith as to the IRS's issuance of the summons at issue and therefore neither basis supports a conclusion that an evidentiary hearing is warranted.

A. Legal Standard

"[S]ummons enforcement proceedings are to be 'summary in nature.'" *Clarke*, 134 S. Ct. at 2367 (*quoting United States v. Stuart*, 489 U.S. 353, 369 (1989)). "[C]ourts may ask only whether the IRS issued a summons in good faith, and must eschew any broader role of 'oversee[ing] the [IRS's] determinations to investigate." *Id*. (*quoting Powell*, 379 U.S. at 56). Accordingly, an evidentiary hearing is not automatically or normally held.

Instead, a party who seeks an evidentiary hearing must show "specific facts or circumstances plausibly raising an inference of bad faith" or improper motive. *Id*. at 2367-68.[8] "Naked allegations of improper purpose are not enough . . . [the party] must offer some credible evidence supporting his charge." *Id.* at 2368. "That standard will ensure inquiry where the facts and circumstances make inquiry appropriate, without turning every summons dispute into a fishing expedition for official wrongdoing." *Id*.

B. Microsoft has failed to meet the requirements of *Clarke*

1. Microsoft's contention that the IRS is attempting to outsource an inherently governmental function presents a legal question.

The first basis on which Microsoft relies to argue it is entitled to an evidentiary hearing is that — by allowing a third-party contractor to question witnesses at summons interviews — the

[8] *Clarke* did not change existing law, and the Supreme Court granted certiorari in order to correct the Eleventh Circuit's standard that a bare allegation of improper purpose entitled a party to an evidentiary hearing in an IRS summons enforcement case. *Cf. United States v. Ali*, No. PWG-13-3398, 2014 WL 5790996 at *4 (D. Md. Nov. 5, 2014). *Clarke* is consistent with pre-existing Ninth Circuit precedent. *See Fortney*, 59 F.3d at 121 (requiring "some minimal amount of evidence" beyond "mere memoranda of law or allegations"), *cited in Clarke*, *supra*, at 3267 n.2.

IRS is attempting to outsource an inherently governmental function, and is enlisting the Court's process to do so.[9] This contention does not present facts or circumstances plausibly raising an inference of bad faith. Instead, it presents a legal question that does not properly fit into the framework in determining whether a party is entitled to an evidentiary hearing under *Clarke*. Certain of the summonses demand interviews. The IRS intends to allow Quinn Emanuel to receive, review, and use summoned books, papers, records, or other data; be present during summons interviews; question the person providing testimony under oath; and ask a summoned person's representative to clarify an objection or assertion of privilege, all in the presence and under the guidance of an IRS officer or employee. *See* Treas. Reg. § 301.7602-1T. Microsoft argues that Quinn Emanuel's participation violates federal law because it claims that such action amounts to outsourcing an inherently governmental function. Microsoft further contends that, by having the Court enforce these IRS summonses, the IRS is abusing the Court's process.

Microsoft has prematurely and inappropriately raised this issue. The Court will ultimately decide this issue in this case but is not required to, nor should it, do so now.[10] The issue now is whether Microsoft has presented "specific facts and circumstances plausibly raising an inference of bad faith" or improper motive. Having Quinn Emanuel be present and ask questions at summons interviews as part of the summons process, in the presence and under the guidance of an IRS officer or employee, does not "plausibly raise an inference of bad faith" or

[9] Although the summons does not specifically state that the IRS intends to have a third party ask questions at the summons interview, the IRS notified Microsoft and the summoned parties that it intended to have its contractors present and asking questions of the summoned parties pursuant to the summons. Docket No. 36, ¶ 11, Ex. C.

[10] Microsoft agrees that the Court need not decide this substantive issue at this time. *See* Microsoft Memorandum in Support, p. 13. In fact, the briefing schedule in these consolidated cases explicitly provides that the parties will brief the common defenses to enforcement of the summonses after the Court rules on Microsoft's motion for an evidentiary hearing. *See* Docket No. 29. Although the United States provides some discussion as to why Treas. Reg. § 301.7602-1T(b)(3) is valid, *infra* pp. 17-20, this issue will be more fully addressed during the subsequent briefing pursuant to the Court's Briefing and Hearing Scheduling Order (Docket No. 29).

improper purpose because it has not been established that the IRS cannot legally do so. If the Court ultimately rules in favor of the United States on this legal issue and finds that the IRS is not doing anything illegal or improper, then there is no abuse of the Court's process or bad faith. Thus, this argument cannot and should not be considered in determining whether Microsoft is entitled to an evidentiary hearing (and ultimately discovery). In any event, even if the Court ultimately determines that Quinn Emanuel cannot ask questions or even be present at summons interviews, the Court can still enforce the summonses. Nothing on the face of the summonses stated or otherwise conditioned their issuance on Quinn Emanuel being allowed to be present and ask questions during the summons interviews.

2. The IRS's decision to allow Quinn Emanuel to be present and ask questions during a summons interview is legally supported.

Notwithstanding Microsoft's premature and inappropriate raising of this issue now, the IRS's decision to allow Quinn Emanuel, as part of the summons process, to be present and ask questions during summons interviews, in the presence and under the guidance of an IRS officer or employee, is fully supported by the law, and no evidentiary hearing is necessary or appropriate. Congress has delegated to the Secretary the authority to "prescribe all needful rules and regulations for the enforcement" of the Internal Revenue Code. *See* I.R.C. § 7805(a). In addition, I.R.C. § 6103(n) provides that the IRS can disclose tax returns and tax return information to any person to the extent necessary to "provid[e] [] other services, for purposes of tax administration" without violating Section 6103(a)'s general ban on disclosure of any such information. Section 6103(b)(4) defines "Tax administration" broadly as including "the administration, management, conduct, direction, and supervision of the execution and application of the internal revenue laws . . . and [] includes assessment, collection, enforcement, litigation, publication, and statistical gathering functions under such laws." And, as with all federal

government management, IRS management officials have the authority to "assign work, to make determinations with respect to contracting out, and to determine the personnel by which agency operations shall be conducted." 5 U.S.C. § 7106(a)(2)(B). Thus, there can be no dispute that Congress has delegated, and intended to delegate, to the IRS the authority to use contractors to assist in the tax enforcement process.

It is correct that a contractor cannot perform an inherently governmental function. *See* Federal Activities Inventory Reform Act of 1998, 31 U.S.C. § 501 Note ("FAIR Act), § 5(2)(A) 48 C.F.R. § 7.503(a). But Microsoft fails to acknowledge that inherently governmental functions do not normally include "gathering information for or providing advice, opinions, recommendations, or ideas to Federal Government officials." *See* 31 U.S.C. § 501 note, at § 5(2)(C)(i); *see also* 48 C.F.R. § 2.101. That is precisely the role Quinn Emanuel is playing with respect to the IRS's examination of Microsoft: Quinn Emanuel is assisting in gathering facts and evidence, as well as providing advice, opinions, and recommendations to the IRS to assist the IRS in performing its examination. Asking questions of witnesses as part of the summons process is part of the fact gathering that occurs during an IRS examination and thus does not amount to an inherently governmental function. On page 11 of its supporting memorandum, Microsoft cites to an example, set forth in *The Office of Management and Budget, Office of Federal Procurement Policy Letter 11-01, Performance of Inherently Governmental and Critical Functions*, of representation of the government before administrative and judicial tribunals as an inherently governmental function and then intimates that is what Quinn Emanuel has been contracted to do. Microsoft's comparison is unfounded. The contract reveals that Quinn Emanuel is not representing the Government before *any* tribunal. Instead, the facts demonstrate

that Quinn Emanuel is merely assisting the IRS during the fact finding process that is part of the IRS's examination.

Further legal support for allowing Quinn Emanuel to be present and question witnesses as part of the summons process is found in Treas. Reg. § 301.7602-1T(b)(3), which provides as follows:

> For purposes of this paragraph (b), a person authorized to receive returns or return information under section 6103(n) and § 301.6103(n)–1(a) of the regulations may receive and examine books, papers, records, or other data produced in compliance with the summons and, in the presence and under the guidance of an IRS officer or employee, participate fully in the interview of the witness summoned by the IRS to provide testimony under oath. Fully participating in an interview includes, but is not limited to, receipt, review, and use of summoned books, papers, records, or other data; being present during summons interviews; questioning the person providing testimony under oath; and asking a summoned person's representative to clarify an objection or assertion of privilege.

The Treasury issued this temporary regulation on June 18, 2014, pursuant to I.R.C. § 7805(a). Treas. Reg. § 301.7602-1T expressly provides that it applies only to summons interviews conducted on or after June 18, 2014. *See* Treas. Reg. § 301.7602-1T(d).

Microsoft first contends that Treas. Reg. § 301.7602-1T(b)(3) is invalid because it contravenes the unambiguous language of I.R.C. § 7602(a)(3), which provides that the Secretary is authorized to take testimony as part of the IRS's examination process. Microsoft is wrong. The Internal Revenue Code does not define the phrase "take testimony," and that phrase has been used in many different circumstances. Further, Section 7602 does not define how an IRS summons interview should be conducted or who may directly participate. Since the statute is unclear, the Secretary has provided guidance, pursuant to his authority under I.R.C. §§ 7805(a) and 6103(n), as to who is allowed to be present and ask questions during an IRS summons

interview. Because Treas. Reg. § 301.7602-1T(b)(3) is a reasonable interpretation of Section 7602, the Court should afford deference to it. *See Chevron v. U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 844 (1984); *see also Mayo Found. For Medical Educ. And Research v. United States*, 562 U.S. 44, 55-58 (2011). Temporary Treasury regulations are also afforded *Chevron* deference. *See Hospital Corporation of America & Subsidiaries v. Commissioner*, 348 F.3d 136, 140 (6th Cir. 2003); *UnionBanCal Corp. v. Commissioner*, 305 F.3d 976, 983-85 (9th Cir. 2002).

Next, contrary to Microsoft's unsupported assertion, Treas. Reg. § 301.7602-1T(b)(3) does not violate the requirements of the Administrative Procedure Act ("APA"). Microsoft contends that the Treasury could not issue Treas. Reg. § 301.7602-1T(b)(3) "without following notice-and-comment procedures" but does not define what it believes those procedures entail. Presumably Microsoft contends that the Treasury was required to provide the public with pre-promulgation notice and comment under the APA, which would have entailed a general notice of rulemaking in the Federal Register (5 U.S.C. § 553(b)) and an opportunity for interested parties to comment on the rulemaking (5 U.S.C. § 553(c)). This argument ignores the difference between a temporary Treasury regulation and a final Treasury regulation and completely disregards I.R.C. § 7805(e), which specifically addresses the procedural requirements applicable to temporary Treasury regulations.

While Microsoft is correct that the APA requires an agency to adhere to notice-and-comment procedures under the APA before promulgating a *final* regulation, there is no such requirement with respect to a temporary Treasury regulation. I.R.C. § 7805(e) provides that any *temporary* regulation issued by the Treasury shall also be issued as a proposed regulation and that any such temporary regulation is valid for only three years after the date it is issued.

Accordingly, a temporary Treasury regulation is not subject to pre-promulgation notice and comment since it is subject to notice-and-comment procedures *after* issuance, due to it being simultaneously issued as a proposed regulation.[11] "[W]hen Congress sets forth specific procedures that 'express[ ] its clear intent that APA notice and comment procedures need not be followed,' an agency may lawfully depart from the normally obligatory procedures of the APA." *Asiana Airlines v. FAA*, 134 F.3d 393, 398 (D.C. Cir. 1998) (citation omitted). If the absence of notice and comment renders temporary regulations invalid (as Microsoft contends), then Section 7805(e) is meaningless. Microsoft's argument thus violates the canon of construction that "'a legislature is presumed to have used no superfluous words,'" *Bailey v. United States*, 516 U.S. 137, 145 (1995) (citation omitted), and should be rejected.

Lastly, Microsoft argues that Treas. Reg. § 301.7602-1T(b)(3) is arbitrary and capricious because it relies on factors that Congress did not intend the Treasury to consider. Specifically, Microsoft complains that Congress requires agencies to consider whether delegation of actions to a contractor amounts to delegating inherently governmental functions, and that Treas. Reg. § 301.7602-1T(b)(3), allowing contractors to be present and question witnesses at an IRS summons interview, is "substantially the same as" the inherently governmental function of representing the Government before administrative and judicial tribunals. As discussed above, Treas. Reg. § 301.7602-1T(b)(3) does not delegate to contractors an inherently governmental function. Further, Microsoft has not pointed to any evidence that the contractor here, Quinn Emanuel, is representing or attempting to represent the Government before *any* tribunal. Instead,

[11] That is exactly what happened here. Notice of proposed rulemaking by cross-reference to temporary regulations was issued on June 18, 2014, concurrent with issuance of the temporary regulation. *See* 79 Fed. Reg. 34668-69. After issuance of Treas. Reg. § 301.7602-1T(b)(3), the Texas State Bar Association provided comments.

the facts demonstrate that Quinn Emanuel is assisting the IRS during its fact-finding process as part of the IRS's examination. Accordingly, Microsoft's argument should be rejected.

3. The facts and circumstances do not raise a plausible inference that the IRS has "outsourced" the Examination to Quinn Emanuel.

Microsoft's factual attempts to meet the *Clarke* standard also fall short. Microsoft argues that the timing of the awarding of the Quinn Emanuel contract gives rise to the inference that Quinn Emanuel was the driving force behind the July (and, presumably, August and October) IDRs, and also behind having the September and October interviews recorded. Microsoft also argues that the IRS's response to its FOIA requests shows the IRS was attempting to conceal Quinn Emanuel's involvement. But these are simply temporal correlations; there is not a scintilla of evidence supporting any inference that Quinn Emanuel was directing the Examination.[12] The IRS was at all times controlling and directing the course of the Examination.

To show alleged impropriety, Microsoft attempts to connect the dots between the IRS awarding the Quinn Emanuel contract in May 2014, and the IRS issuing what Microsoft terms "a flood of new requests" for documents, in July 2014; but there is no connection to be made. As established in the Second Hoory Declaration, although the contract was formally awarded in May 2014, Quinn Emanuel did not begin its work under the contract until July 15, 2014 — that is, *after* the July 2014 document requests had been issued. Moreover, as the Second Hoory Declaration makes clear, Quinn Emanuel's role throughout has been simply to provide an advisory and supporting role, given its expertise in fact-intensive and expert-dependent positions. The Second Hoory Declaration also provides a comprehensive look at how the IRS managed the Microsoft Examination from 2012 onwards, and compels the conclusion that all the work Quinn

[12] As the Ninth Circuit has cautioned in a different context, the law does not compel a finding of causation based merely on "the 'logical fallacy of *post hoc, ergo propter hoc'* (literally, 'after this, therefore because of this')." *Kozulin v. INS,* 218 F.3d 1112, 1117 (9th Cir. 2000).

Emanuel has performed under the contract was completely proper and done under the direction of IRS employees, who at all times made the final determinations, including during the time period from July 15, 2014 onwards, when Quinn Emanuel began work under the contract.

Microsoft also purports to find Quinn Emanuel's hand in the fact that the September and October 2014 interviews of current and former Microsoft employees were recorded. Again, there is no factual support for this assertion. During an examination the IRS is statutorily permitted to record an interview, 26 U.S.C. § 7521(a)(2), and although the earlier interviews in the Examination were entirely informal and not recorded, that was purely an accommodation to Microsoft to which the IRS acceded. (Second Hoory Declaration ¶ 28.) While Microsoft describes the September and October recorded interviews as "an abrupt departure" (Memo, at 5) from the IRS's prior practice, in fact the IRS had been conferring with Microsoft about having recorded interviews since at least March 2014 (*id*. ¶ 44) — that is, well before Quinn Emanuel was retained — and Microsoft was aware as early as 2012 that the IRS might seek to record subsequent interviews for the Examination. (*Id.*¶¶ 28, 31, and Exhibits B and C to Second Hoory Declaration.) And, again, even if Quinn Emanuel did recommend that the IRS record the interviews, that would be the very type of advice that a contractor hired for its expertise in fact investigations would be expected to provide.

Microsoft also argues that the IRS delayed disclosing its retention of Quinn Emanuel. But it was Mr. Hoory who disclosed to Microsoft (in a letter to Mr. Bernard of the tax department), on August 28, 2014, that the IRS had retained Quinn Emanuel. (Bernard Declaration ¶ 16.) The timing of this disclosure was appropriate, as it was made after the necessary administrative processes were completed and before the upcoming September and

October interviews, which was the first time Quinn Emanuel attorneys would have any contact with Microsoft or its employees.

Moreover, regardless of when Microsoft obtained the contract documents, the point remains that the contract documents fail to show any impropriety whatsoever. Quinn Emanuel was hired to provide advice to the IRS during the course of the Examination; Quinn Emanuel is legally allowed to provide such advice; and it has in fact been providing such advice.

II. Microsoft has failed to establish that discovery is warranted

As Microsoft concedes, it is well settled that district courts are not required to permit discovery or conduct evidentiary hearings in proceedings to quash or enforce IRS summonses. *United States v. Stuart*, 489 U.S. 353, 369 (1989); *United States v. Church of Scientology of California*, 520 F.2d 818, 821 (9th Cir. 1975). This is in recognition of the established principle that summons enforcement proceedings are intended to be summary in nature. *Chen Chi Wang v. United States*, 757 F.2d 1000, 1004-05 (9th Cir. 1985) (taxpayer's discovery request for production of all documents concerning the creation, formulation, and promulgation of a Treasury regulation in a summons matter was properly denied because of the summary nature of summons proceedings). "The district court in a summary summons enforcement proceeding has great discretion to restrict or deny discovery; discovery . . . is the exception rather than the rule." *Id.* "The party resisting enforcement should be required to do more than allege an improper purpose before discovery is granted." *Church of Scientology*, 520 F. 2d at 824. That is because allowing discovery in what is meant to be a summary proceeding would place undue burdens on the IRS and improperly impede the summons enforcement procedure. *Id.* In the Ninth Circuit, limited discovery is allowed in summons enforcement proceedings only if after an evidentiary hearing is held "the taxpayer can make a substantial preliminary showing of abuse or wrongdoing." *United States v. Stuckey*, 646 F.2d 1369, 1374 (9th Cir. 1981). Conclusory

allegations that the summons was issued for an improper purpose are not sufficient to justify discovery in a summons proceeding. *Adamowicz v. United States*, 531 F.3d 131, 160 (2d Cir. 2008).

Microsoft has failed to meet even the evidentiary standard required to warrant an evidentiary hearing. That same "evidence" certainly cannot meet the requisite "substantial preliminary showing" to justify the taking of discovery. Mere speculation and supposition, which is the sum total of what Microsoft has offered this Court in its motion, is not sufficient to meet the burden imposed for discovery in a summons matter. Rather, the evidence presented by the United States makes quite clear that enforcement of the summons would not be an abuse of this court's process because the underlying audit is not being directed by Quinn Emanuel, *supra* § I.B.3. Moreover, the validity of the temporary regulation is a legal question that does not substantiate the conducting of discovery, *supra* § I.B.2.

Furthermore, Microsoft readily admits that the document discovery it seeks is the same materials for which it has already made FOIA requests and has also filed suit.[13] This sort of litigation tactic is not what prior courts were contemplating when articulating the exceptional summons enforcement case where discovery is justified.

Finally, even if Microsoft is permitted limited discovery under Rule 34, the United States would still be entitled to assert the traditional privileges available to a party in discovery. In this instance, assuming the United States receives requests for production similar to what Microsoft has proposed — that is, documents maintained by the IRS relating to the temporary Treasury

[13] Microsoft has submitted to the IRS five FOIA requests on matters related to issues it has raised in its pleadings in this case. Four of the requests, which were submitted in December 2014, are the subject of a pending FOIA suit, *Microsoft Corp. v. Internal Revenue Service*, No. 2:15-cv-00369 (W.D. Wash.), filed March 11, 2015. The first FOIA request was resolved in *Microsoft Corp. v. Internal Revenue Service*, No. 1:14-cv-01982) (D.D.C.), filed November 24, 2014. *See* Declaration of Scott Hovey and Exhibits A-E thereto.

regulation at issue (similar to the properly denied discovery request made in *Chen Chi Wang*, 757 F.2d at 1004-05); documents exchanged between the IRS and Quinn Emanuel; and internal IRS employee documents about the temporary regulation, the Examination, and the contract with Quinn Emanuel — the United States would object because a large part of that material is protected from production by either the attorney-client privilege or deliberative process privilege. *See NLRB v. Sears, Roebuck & Co.,* 421 U.S. 132, 150 (1975) (deliberative process privilege permits government to withhold documents that "reflect[ ] advisory opinions, recommendations and deliberations comprising part of a process by which governmental decisions and polices are formulated." (quotation marks omitted)); s*ee also Lahr v. Nat'l Transp. Safety Bd.,* 569 F.3d 964, 979 (9th Cir. 2009) (deliberative process privilege "shields certain intra-agency communications from disclosure to allow agencies freely to explore possibilities, engage in internal debates, or play devil's advocate without fear of public scrutiny" (internal citation and quotation marks omitted)). To the extent that Microsoft seeks discovery here because it believes it will receive documents sooner than it will by its FOIA request, that belief is misplaced, as Microsoft would still be required to overcome the United States' assertions of privilege.[14]

[14] Even in the FOIA context, an agency is not required to disclose records under 5 U.S.C. § 552(a) that "may be withheld pursuant to one of the nine enumerated exemptions listed in § 552(b)." *United States Dept. of Justice v. Tax Analysts*, 492 U.S. 136, 150-51 (1989) (quoting *Department of Justice v. Julian*, 486 U.S. 1, 8 (1988)). Again, based on the nature of the request proposed by Microsoft in its motion, the United States will likely assert that several of the statutory exemptions apply to justify withholding documents from disclosure.

CONCLUSION

Microsoft has failed to present credible evidence that plausibly raises an inference of abuse and has likewise failed to make the "substantial" preliminary showing of abuse necessary in order for it to be permitted to take discovery. Accordingly, Microsoft's motion for an evidentiary hearing and for discovery should be denied.

Dated this 14th day of April, 2015.

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CERTIFICATE OF SERVICE

IT IS HEREBY CERTIFIED that service of the foregoing has been made this 14th day of April, 2015, via the Court's ECF system to all parties and electronically to the following:

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